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Summary

1. (SBU) Summary. The third session of the U.S.-China Strategic Economic Dialogue (SED) focused on Balanced Economic Development. Both sides agreed on the need for further economic reforms, but Chinese interlocutors insisted that reforms take place gradually to

avoid "overshooting." The Chinese side expressed concern that the United States sub-prime mortgage crisis would adversely affect the Chinese economy. Treasury Secretary Paulson underscored U.S. efforts to address the sub-prime crisis and assured his counterparts that the U.S. economy would continue to serve as an engine for growth. End Summary.

Paulson Urges Quickening the Pace of Reform

2. (SBU) During a discussion on Balanced Economic Growth on December 12, Treasury Secretary Henry Paulson attributed imbalances in both the U.S. and Chinese economies to structural issues. He described U.S. efforts to address U.S. domestic imbalances by resolving the sub-prime mortgage crisis, addressing the entitlement process, and increasing domestic savings rates. Paulson urged Chinese leaders to quicken the pace of Chinese domestic reforms, noting that reforms work best if executed during a time of economic strength rather than in response to a crisis. Commerce Secretary Carlos Gutierrez echoed Paulson's support for reforms, and encouraged Chinese leaders to continue efforts to build a social safety net for its citizens and strengthen innovation by further opening the market to foreign competition.

PBOC: China Must Go Slow

3. (SBU) People's Bank of China (PBOC) Governor Zhou Xiaochuan agreed that China should move forward with economic reforms but at a gradual pace. He warned that moving too quickly could lead to an "overshooting" of corrections, tipping imbalances in the opposite direction and generating new problems. Zhou cited a cultural analogy to describe the differences between U.S. and Chinese approaches to reform: "Chinese people use traditional Chinese medicine to address the root causes of a disease, but it often takes longer for the body to get well. The United States, on the other hand, uses Western medicine to address only the symptoms of a disease, but this does not necessarily resolve the underlying illness." China's reform measures -- aimed at reducing income gaps across the country and shifting the economy away from an export-driven growth model -- similarly target the root causes of China's economic imbalances, but will take a longer time to affect the economy as a whole.

4. (SBU) Zhou said that domestic imbalances in both countries complement one another, and stressed the importance of lowering savings rates and increasing consumption in China, while increasing savings and reducing consumption in the United States. He noted, however, that it is difficult to reach a proper equilibrium, as a high rate of consumption in the United States serves as an engine for global economic growth. Zhou expressed concern about the impact of the sub-prime mortgage crisis on China's economy. In Zhou's view, excess liquidity resulting from the U.S. Federal Reserve's lowering of interest rates in the wake of the sub-prime crisis could contribute to excess liquidity in China and other countries. "China already faces an excess liquidity problem," he said, "so we are concerned that this will create ethical risks (moral hazard)."

MOF: Maintain a Stable Dollar

5. (SBU) Minister of Finance Xie Xuren emphasized China's use of fiscal policy to promote balanced economic growth. Xie stated that China is strengthening the central government's transfer payments system to promote growth in central and western regions. He reported that China has also eliminated agricultural taxes and subsidized agricultural production to narrow the wealth gap between urban and rural areas. In support of "scientific development"

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policies aimed at protecting the environment and steering investment toward high tech industries, China has also reduced and/or eliminated VAT refunds on certain categories of exports whose manufacture causes heavy pollution. Xie asserted that "developed countries like the United States should shoulder more of the burden for addressing global economic imbalances." He urged the United States to maintain the U.S. dollar at a stable exchange rate, increase technology exports, lower the budget deficit, and reduce trade protectionism. Paulson replied that a large market-driven economy like the United States will always have ups and downs, and reminded Xie that the market determines the value of the U.S. dollar.

CBRC on Financial Services

6. (SBU) China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang stated that CBRC will soon sign an Exchange of Letters (EOL) with the U.S. Securities and Exchange Commission that would facilitate Chinese fund managers to invest in U.S. stock markets. Liu also encouraged U.S. banks to focus on rural banking, noting that Citigroup and AIG have already expressed an interest in investing in new types of financial institutions in rural areas. On pension management, Liu said that "once the greenlight is lit" foreign financial services firms will receive national treatment in the enterprise annuity (pension management) business, but declined to elaborate on a time frame. Liu welcomed the recent licensing of China Merchants Bank's New York branch and encouraged the United States to reduce the time it will take to approve licenses for Industrial and Commercial Bank of China (ICBC) and China Construction Bank (CCB). He also asked the United States to provide national treatment to Chinese banks already operating in the United States. Noting concern about the recent sub-prime crisis, Liu urged the United States to prevent future crises through enhanced bilateral financial information sharing mechanisms and strengthened supervision of financial institutions. Liu stressed recent progress on foreign bank cards, and noted that CBRC has already approved issuance of several foreign bank cards. The card data processing and storage however, must meet PBOC technical standards, he explained, urging U.S. financial institutions to continue discussions with PBOC.

CSRC on Opening the Securities Market

7. (SBU) China Securities Regulatory Commission (CSRC) Chairman Shang Fulin stated that "China has faithfully followed up on commitments to open the securities market." He cited recent achievements, including the approval of NYSE and NASDAQ offices in China and an extension of QFII quotas from USD 10 billion to USD 30 billion. He expressed concern about excess liquidity and weak infrastructure in domestic capital markets, stressing that the stock market has "accumulated risk." Shang stated that the CSRC will further open the securities sector, "under the precondition of ensuring financial stability."

8. (SBU) U.S. Trade Representative Schwab urged China to end discriminatory treatment of foreign insurance firms opening branches in China, noting that foreign firms can file only one branch application at a time whereas Chinese firms can file multiple applications. CIRC Chairman Wu Dingfu replied that premium income for foreign insurance companies in China continues to rise, and that foreign insurance firms' 48.7 percent growth rate is higher than that of Chinese firms. "This proves we have been honoring our WTO commitment," he claimed.

9. (SBU) Secretary Paulson closed the discussion, stating that the United States and China have a shared responsibility to address economic imbalances. He encouraged China to move forward quickly with reforms and stressed that if regulation had preceded innovation in the United States, it would have had a negative impact on the development of the U.S. economy.

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